Summary of Testimony of
Douglas W. Smith, General Counsel
Federal Energy Regulatory Commission
before the
Subcommittee on Energy and Power
Committee on Commerce
United States House of Representatives

May 6, 1999

The Federal Energy Regulatory Commission has established an overarching goal of promoting competition in wholesale power markets, having concluded that effective competition, as opposed to traditional forms of price regulation, can best protect the interests of ratepayers. Market power, however, can be exercised to the detriment of effective competition, raising prices to customers. Market power may take many forms, including control of access to transmission facilities necessary to deliver electricity, concentration in generation markets, or control of inputs to generation. Thus, the Commission regulates transmission service, mergers, and wholesale power rates so as to prevent the exercise of market power in bulk power markets.

As Congress considers electricity legislation, it will be important to ensure that appropriate and effective tools are available to address market power issues if competition is to continue to grow in the wholesale power markets. For example, statutory changes to ensure open access to a reliable and efficiently-operated transmission grid should be a priority in any legislative reform. Other reform proposals that would enhance our ability to address market power concerns and promote competitive bulk power markets also deserve careful consideration.

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Mr. Chairman and Members of the Subcommittee:

Good morning. My name is Douglas Smith, and I am the General Counsel for the Federal Energy Regulatory Commission. I am here today as a Commission staff witness, and do not speak for the Commission itself or for individual members of the Commission. Thank you for the opportunity to appear before you today to discuss competition policy in the electric industry, and particularly the issues of market power, mergers and the Public Utility Holding Company Act of 1935 (PUHCA).

One of the Commission's overarching goals is to promote competition in wholesale power markets, having concluded that effective competition, as opposed to traditional forms of price regulation, can best protect the interests of ratepayers. Market power, however, can be exercised to the detriment of effective competition and consumers. Thus, the Commission regulates transmission service, mergers, and wholesale power rates so as to prevent the exercise of market power in bulk power markets. As Congress considers electricity legislation, it will be important to ensure that appropriate and effective tools are available to address market power issues if competition is to continue to grow in the bulk power markets.

I. **Market Power**

In enacting Part II of the Federal Power Act (FPA) in 1935, one of the primary Congressional goals was to protect electric ratepayers from abuses of market power. In furtherance of this goal, Congress directed the Commission to oversee sales for resale and transmission service provided by public utilities in interstate commerce. Under sections 205 and 206, the Commission must ensure that the rates, terms and conditions of these services are just, reasonable, and not unduly discriminatory or preferential. Under section 203, the Commission must review proposed mergers, acquisitions and dispositions of jurisdictional facilities by public utilities, if the value of the facilities exceeds $50,000, and must approve such transactions if they are consistent with the public interest. The Commission's regulation under these sections applies only to "public utilities," which mainly include investor-owned utilities and exclude the federal power marketing administrations, municipal utilities, and most rural electric cooperatives.

The traditional regulatory approach was to accept that electric utilities were natural monopolies, and to address market power and protect ratepayer interests primarily by relying on cost-of-service rate regulation.

In the 1980s and early 1990s, industry developments indicated that the interests of ratepayers could be better protected by competition in generation markets than by cost-based regulation for wholesale sales. The benefits of competition in place of traditional regulation were increasingly evident in other industries, such as trucking, railroads, telecommunications and natural gas. Also, prompted by a range of economic, legislative and technological factors, some competition among generators already had begun developing in the electric industry. One key factor was the Public Utility Regulatory Policies Act of 1978 (PURPA), which opened the door for non-utility generators.

In the Energy Policy Act of 1992, Congress strongly endorsed competition in wholesale power markets with amendments to the FPA and PUHCA. The Commission has pursued this pro-competition focus by ordering open access to transmission facilities in Order No. 888, and in its merger and wholesale rate policies. The Commission's primary focus has shifted from cost-based ratemaking to creating the conditions for robust competition. This transition has required the Commission to pay increasing attention to issues of market structure, market power and market monitoring.

Competition in bulk power markets can be diminished or blocked by the exercise of market power. Market power may take many forms, including control of access to transmission facilities necessary to deliver electricity, concentration in generation markets, or control of inputs to generation such as fuel.

Market power problems can result in higher prices to customers. For example, absent regulation, a vertically-integrated utility could prevent its competitors in wholesale power markets from using its transmission facilities to deliver power to buyers. Buyers then would have fewer competitive options and, as a result, may have to pay higher prices. Similarly, a utility with a large enough share of the generating capacity in a market can raise prices by withholding supply from the market. A utility that controls enough of an input to power production (such as pipeline capacity for delivering natural gas to power plants) can achieve the same result.

Market power can be created or enhanced by mergers. Mergers can eliminate a competitor from the market and concentrate control of generating assets. Mergers can also enhance vertical market power, by giving the merged company a new or increased ability and incentive to restrict inputs to power production.

Discussed below are five key market power issues: transmission market power; market-based rates for sales of power; mergers of public utility facilities; State regulation of market power; and possible legislative reforms.

A. Transmission Market Power

Market power considerations related to ownership and control of transmission facilities are at the core of the Commission's open access transmission policies. Fair and open access to reliable transmission service is an essential predicate to competition in bulk power markets. Effective regulation of the relatively small transmission sector (which accounts for 10% of overall utility costs) enables competition, with its consequent ratepayer benefits, in the much larger generation sector (which accounts for 60% of total utility costs).

In the Energy Policy Act of 1992, Congress broadened the Commission's authority under section 211 of the FPA to require transmission service on a case-by-case basis. This legislation, as implemented by the Commission, helped to expand the trading opportunities of wholesale sellers and buyers. However, the Commission concluded that competition in wholesale markets still was being inhibited by the lack of non-discriminatory access to transmission facilities. Generation sellers owning transmission facilities were stifling competition by discriminating against competing sellers that sought to use their transmission facilities, either by denying or delaying transmission service or by imposing discriminatory rates, terms and conditions for service. The Commission recognized that it needed to act generically to provide for open access transmission if it was to meet the Congressional goal of developing competitive wholesale markets.

Consequently, the Commission in 1996, through a major rulemaking called Order No. 888, ordered open (non-discriminatory) access to the transmission facilities of public utilities. Order No. 888 allows transmission customers to obtain service that they could not previously obtain, and to secure those services more quickly and with more certainty about rates, terms and conditions. This open access obligation prohibits public utilities from discriminating against competitors' transactions in favor of their own wholesale sales of power.

In Order No. 888, the Commission also encouraged, but did not require, the formation of independent system operators (ISOs) to promote broader, regional power markets and provide greater assurance of non-discrimination. Since then, six ISOs have been established (in California, the mid-Atlantic states, New England, New York, the Midwest and Texas), and four of these are currently operational.

The Commission is seeking further improvements in transmission access and grid operation to support fully competitive wholesale power markets. Of particular importance, it is exploring how it might promote the formation of regional transmission organizations (RTOs) such as ISOs and independent companies that own and operate transmission facilities (transcos). An RTO that covers an appropriately configured region, has adequate operational control over the transmission grid, and is independent of the financial interests of power market participants, can address obstacles to competition by reducing rate pancaking, eliminating opportunities for bias in transmission operations, and allowing for more efficient and reliable operation and planning of the transmission grid.

As FERC's Chairman Hoecker testified before this Subcommittee two weeks ago, legislation on transmission issues is needed to ensure the full development of wholesale competition and maintain our high standard of reliability. Specifically, Chairman Hoecker recommended legislation that would: bring all transmission facilities in the lower 48 states within the Commission's open access transmission rules; clarify the Commission's authority to promote regional management of the transmission grid through regional transmission organizations; and, establish a fair and effective program to protect bulk power reliability. Addressing these transmission-related issues should be a priority in any legislative reform agenda.

B. Market-Based Rate Review

To promote competition, the Commission allows market-based rates for wholesale sales of electricity when an applicant shows that it and its affiliates lack or have mitigated market power. In evaluating horizontal market power for these purposes, the Commission distinguishes between new generating facilities and existing facilities. For sales from new generating facilities, the Commission applies a rebuttable presumption that the applicant lacks generation market power, but intervenors may present specific evidence to the contrary. For sales from existing generating facilities, the Commission uses a case-specific analysis of whether the applicant and its affiliates control a significant share of the total generation capacity that can be accessed by the utilities directly interconnected to the applicant or its affiliates. The Commission's general benchmark for concern is a market share of 20 percent or more.

In evaluating vertical market power for these purposes, the Commission considers the extent of the applicant's control of any inputs to power production. Most applicants for market-based rates lack significant control of such inputs and thus present no vertical market power concerns. The Commission analyzes the control of transmission facilities separately from other sources of vertical market power and, for purposes of market-based rates, currently accepts compliance with Order No. 888's open access requirements as adequate mitigation of transmission market power.

If an applicant or its affiliates appear to have market power that has not been mitigated, the Commission generally will deny market-based rates. Alternatively, the Commission may preclude the use of an applicant's market-based rates in specific geographic areas in which the applicant fails to demonstrate a lack of market power, or may impose other appropriate conditions on the use of market-based rates.

Should the Commission identify market power problems after market-based rates have been authorized, it can revoke market-based rates and return to cost-of-service regulation. This remedy does not eliminate the underlying market power but, instead, relies on price regulation to mitigate the potential for its exercise.

C. Merger Review

The Commission considers market power issues in reviewing applications for mergers or other jurisdictional acquisitions or dispositions of assets. In a merger policy statement issued in December 1996, the Commission stated that, in assessing whether a proposed merger was in the public interest, it would consider the effects of the merger on competition, on rates and on regulation. The Commission sought to streamline its merger review process and to reduce filing burdens on merger applicants by adopting the Department of Justice/Federal Trade Commission merger guidelines as the framework for analyzing a merger’s horizontal effects on competition. These guidelines set out five steps for analyzing mergers, based on: (1) whether the merger would significantly increase market concentration; (2) whether the merger would result in adverse competitive effects; (3) whether entry would mitigate the merger’s adverse effects; (4) whether the merger would result in efficiency gains not achievable by other means; and (5) whether, absent the merger, either party would likely fail.

The Commission’s merger policy statement also described a conservative analytical screen for quickly identifying mergers unlikely to raise horizontal market power concerns. The screen analysis focuses on the first step identified in the DOJ/FTC guidelines, i.e., whether the merger would significantly increase concentration. The screen analysis relies on a "delivered price" test to define relevant markets and the suppliers that can deliver power to affected customers at competitive prices. If the screen analysis shows that the proposed merger will not increase market concentration by more than 100 HHI points in a moderately concentrated post-merger market (defined as 1,000 to 1,800 HHI points) or 50 HHI points in a highly concentrated post-merger market (defined as exceeding 1,800 HHI points), the Commission will not set the matter for hearing to further consider competitive effects.

The Commission's analysis of vertical market power concerns is similar. A vertical merger is unlikely to harm competition unless the merged company has the incentive and the ability to affect prices or quantities in the upstream (input) market and the downstream (electricity) market. For example, a company must be able, and have an incentive, to restrict service or raise prices for an input such as natural gas pipeline capacity and, as a result, restrict service or raise prices in supplying wholesale power.

If a merger will create market power or enhance the applicants' market power significantly, mitigation of these effects is required in order to ensure that the merger is consistent with the public interest. Section 203 of the FPA gives the Commission authority to approve a merger conditionally, i.e., subject to "such terms and conditions as it finds necessary or appropriate to secure the maintenance of adequate service and the coordination in the public interest of facilities subject to the jurisdiction of the Commission." In order to mitigate merger-enhanced market power, the Commission has conditioned merger approvals on measures such as providing others with access to the merged company's constrained transmission facilities, and restricting a fuel-supplying affiliate from giving information to its power-selling affiliates about fuel deliveries to competing power sellers.

The Commission's jurisdiction over mergers and acquisitions is limited in certain ways. First, the Commission has no direct jurisdiction over transfers of generation facilities. It can review transactions involving a public utility only when they involve other facilities that are jurisdictional (such as transmission facilities or contracts for wholesale sales). Thus, although concentration of generation assets may directly affect competition in wholesale markets, transactions involving only generation assets may not be subject to FPA review.

Second, the Commission lacks direct jurisdiction over mergers of public utility holding companies. While the Commission has considered such mergers to involve jurisdictional indirect mergers of public utility subsidiaries of the holding companies, or changes in control over the jurisdictional facilities of the public utility subsidiaries, the FPA is not explicit on this point.

These jurisdictional gaps could be usefully addressed in the course of legislative reform.

D. <u>State Issues</u>

Chairman Barton's letter of invitation for this hearing asked that I address the states' ability to effectively address market power issues. The states are well aware of the potential harm caused by market power. To wit, the National Association of Regulatory Utility Commissioners (NARUC) has issued a resolution on market power in a restructured electric power industry which finds that market power abuses "can diminish the economic gains to consumers from a restructured electric power industry, in which long-term consumer interests require that neither incumbents nor new entrants gain or retain unfair market advantage." The resolution also concluded that "after-the-fact antitrust enforcement may not be sufficient to protect against market power abuses in the transition from monopoly to competitive markets."

As States address market power issues in the context of, for instance, merger reviews and retail competition initiatives, certain limits on their ability to protect against market power abuses may become significant. The extent of this concern is best explored with witnesses testifying on behalf of the States. However, I will briefly mention three issues. First, electricity markets are becoming larger, regional markets, and individual states may find themselves geographically limited in their ability to identify and remedy market power problems. Second, state regulators may lack the state law authority or resources needed to tackle new and challenging market power issues. Third, transmission and wholesale sales in interstate commerce may affect retail competition but are within exclusive Federal jurisdiction.

In such circumstances, the States may seek Federal assistance in addressing market power problems in regional electricity markets. The Commission, to the extent of its existing authority, can serve as a backstop for States in circumstances where a State lacks adequate authority and seeks FERC's assistance. For example, FERC has stated its willingness to assess a merger's effects on retail competition if asked by an affected state commission lacking adequate authority under state law. However, in this example, there may be insufficient authority -- State or Federal -- to address market power in retail markets.

E. <u>Legislative Reforms on Market Power</u>

As we seek to rely primarily on competition as opposed to traditional price regulation to protect the interests of ratepayers, regulators must have the range of tools necessary to address market power problems that may threaten competition. Reforms to the Federal statutory scheme are appropriate to permit regulators to keep up with the new market power challenges.

The Administration's newly-proposed bill addresses a number of market power issues. With respect to transmission, the bill would permit the Commission to extend its open access requirements to non-public utilities in the lower 48 States, would clarify the Commission's authority to promote regional management of the transmission grid through RTOs, and would establish a fair and effective program of mandatory reliability standards. Chairman Hoecker testified recently in favor of such changes.

The Administration's bill also would close the gap in the Commission's jurisdiction over mergers involving only generation facilities, and would clarify that holding companies with electric utility subsidiaries cannot merge without Commission review. The bill would further allow FERC to address market power in retail markets, if asked by a state commission lacking adequate authority to address the problem, and would give the Commission explicit authority to address market power in wholesale markets by requiring a public utility to file and implement a mitigation plan. Each of these reforms also deserves careful consideration as you consider legislation to promote competitive electricity markets.

II. Public Utility Holding Company Act

As a general matter, the Securities and Exchange Commission (SEC) regulates registered utility holding companies while FERC regulates the operating electric utility and gas pipeline subsidiaries of the registered holding companies. The agencies often have responsibility to evaluate the same general matter, but from the perspective of different members of the holding company system and for different purposes. FERC focuses primarily on a transaction's effect on utility ratepayers. The SEC focuses primarily on a transaction's effect on corporate structure and investors.

Under section 32 of PUHCA (added by the Energy Policy Act of 1992), FERC must determine whether an applicant meets the definition of an exempt wholesale generator and thus is exempt from PUHCA. With minor exceptions, the SEC continues to make PUHCA exemption determinations under other provisions of PUHCA.

In the area of utility rates, the SEC must approve service, sales and construction contracts among members of a registered holding company system. FERC must approve wholesale rates reflecting the reasonable costs incurred by a public utility under such contracts.

This last example of overlapping jurisdiction has been a subject of concern. In 1992, the United States Court of Appeals for the District of Columbia Circuit held, in Ohio Power Company v. FERC, 954 F.2d 779 (D.C. Cir. 1992) (Ohio Power), that if a public utility subsidiary of a registered holding company enters into a service, sales or construction contract with an affiliate company, the costs incurred under that affiliate contract cannot be reviewed by FERC. The SEC has to approve the contract before it is entered into. However, FERC cannot examine the reasonableness or prudence of the costs incurred under that contract. FERC must allow those costs to be recovered in wholesale electric rates, even if the utility could have obtained comparable goods or services at a lower price from a non-affiliate.

The Ohio Power decision has left a significant gap in rate regulation of electric utilities. The result is that utility customers served by registered holding companies have less rate protection than customers served by non-registered systems. If the contract approval provisions of PUHCA are retained, this regulatory gap should be closed to restore FERC's ability to regulate the rates of utilities that are members of registered holding company systems.

Setting aside the Ohio Power issue, let me address PUHCA more broadly. PUHCA was not crafted with competitive electricity markets in mind. For example, acquisitions by registered holding companies generally must tend toward the development of an "integrated public-utility system." To meet this requirement, the holding company's system must be "physically interconnected or capable of physical interconnection" and "confined in its operations to a single area or region." This requirement tends to encourage geographic concentrations of generation ownership. Similarly, although the 1992 amendments providing for exempt wholesale generators removed regulatory obstacles to new entrants in the wholesale generation market, these new generators cannot compete, under the current exemption, for retail sales in markets where States have provided retail competition.

Any legislation to reform or repeal PUHCA, however, should ensure that the Commission and the States have adequate authority to examine the books and records of all companies in a holding company system that are relevant to costs incurred by an affiliated utility. This type of authority will provide a new, effective tool to protect against affiliate abuse and ensure that remaining captive consumers do not cross-subsidize entrepreneurial ventures.

III. Conclusion

Competition in electricity markets will not effectively protect ratepayers if some market participants can exercise market power. Thus, as we continue to move toward more competitive power markets and remove regulatory controls over sales of power, we must ensure effective regulation of essential transmission facilities and the mitigation of market power. These issues require careful attention by Congress, FERC, the antitrust agencies and our State counterparts. The Federal statutory regime should protect consumers by combining pro-competitive policies with the regulatory tools necessary to constrain market power effectively.

Thank you again for the opportunity to offer my views here this morning. I would be pleased to answer any questions you may have.